Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Monteith — Analyst: Kimberly Pantoja — Bill Number: SB 435

Related Bills: See Legislative History — Telephone: 845-4786 — Introduced Date: 02/21/2001

Attorney: Patrick Kusiak — Sponsor:

SUBJECT: Irrigation System Improvement Costs Credit/Agricultural Water Filtering Systems & Equipment Deduction

SUMMARY

This bill would create a tax credit for the cost of a farm irrigation system improvement that provides water conservation or savings.

This bill also would allow a taxpayer to elect to deduct the costs to construct or purchase a water filter system and equipment used to prevent contaminated agricultural water from entering public waterways.

PURPOSE OF THE BILL

According to the author's staff, this bill is intended to reward agri-businesses for being good stewards of the land entrusted to them by utilizing the tax system to provide a credit for installing an irrigation system improvement.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective upon enactment. The bill would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

An amendment is provided to address the department's technical concern. Department staff is available to assist with amendments to resolve the implementation and policy concerns described below.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	04/03/01
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING		

ANALYSIS

FEDERAL/STATE LAW

Irrigation System Improvements Credit

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or as investment property. The property must have a useful life of more than one year and includes equipment, machinery, vehicles, and buildings, but excludes land. The property is then depreciated over its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. Expenses related to water conservation qualify to the extent that they are ordinary and necessary business expenses and are not for the purchase of property with a useful life of more than one year.

Existing state law provides general rules that apply to the division of credits among two or more taxpayers, a husband and wife, and partners. State law also provides that any credit limitation applies at both the entity and individual taxpayer level, unless otherwise specified.

Existing state and federal laws allow taxpayers to use various credits against tax. Neither state nor federal laws currently have a tax credit similar to the one proposed by this bill.

THIS BILL

Irrigation System Improvements Credit

This bill would allow all taxpayers that own or lease land to claim a tax credit equal to 30% of the costs of purchasing and installing an irrigation system improvement. The system must be used in a business for the production of farm income and result in water conservation or savings.

This provision would extensively define the term "irrigation system improvement" in terms of the types of qualifying equipment and the impact on water use. An irrigation system improvement would also be defined to include a physical improvement, an alteration of real property, or an installation of equipment certified to meet the bill's criteria. Certification can be given by a registered civil engineer, registered agricultural engineer, or certified irrigation designer who is independent of the taxpayer and the seller or provider of the physical improvement, alteration, or equipment.

The basis of the qualified equipment would be reduced by the amount of the allowable credit.

Any excess credit could be carried over indefinitely. However, any unused carryover credit would be disallowed if the taxpayer sells the land on which the qualified equipment was installed.

Water Filter Systems and Equipment Deduction

This provision would allow all taxpayers engaged in an agricultural business (as defined) to elect to deduct the costs for the construction or purchase, or both, of water filter systems and equipment used to prevent contaminated agricultural water from entering public waterways or underground aquifers.

This provision would specify that if an agricultural business is owned by more than one taxpayer, each taxpayer may deduct that portion of the costs paid or incurred with respect to the water filtering systems and equipment proportionate to the taxpayer's interest in the business.

The deduction would only apply to agricultural water filter systems and equipment placed in service in California.

This provision would define the terms "agricultural water filter system and equipment," "contaminated agricultural waters," and "qualified taxpayer."

IMPLEMENTATION CONSIDERATIONS

Irrigation System Improvements Credit

The credit permits, but does not require, an engineer or designer to provide certification of an irrigation system improvement. It would be helpful for audit purposes if an engineer or designer were required to certify every irrigation system eligible for the credit because the department lacks the expertise in farming or water management necessary to determine if a system meets the required criteria.

Also, the requirement that the certifying engineer or designer be "independent of" the taxpayer is a subjective, undefined standard and may be open to interpretation. Providing an objective relationship standard, perhaps by reference to an existing tax law standard defining a "related party," would make it clear that the engineer or designer may not be an employee or otherwise related to the purchaser, seller, or manufacturer of the water application or distribution equipment.

Water Filter Systems and Equipment Deduction

It is unclear when the "agricultural water filter system and equipment" constructed or purchased by the taxpayer would be required to satisfy the requirement to prevent or assist in preventing contaminated water from entering public waterways or underground aquifers.

Current law specifies that the allocation of income, deductions, credits, etc., for partnerships and "S" corporations shall be on the basis of a partner's distributive share pursuant to a partnership agreement or an "S" corporation shareholder's pro rata share. This provision specifies that the deduction shall be allocated in accordance with the interest of each owner in an agricultural business. However, the bill does not provide any clear rule (such as profits interest, capital interests, etc.) to be used in determining owner interests.

TECHNICAL CONSIDERATION

Amendments 1 and 2 are provided to clarify the effective date for the credit.

LEGISLATIVE HISTORY

Irrigation System Improvements Credit

SB 1974 (Poochigian, 1999/2000) contained the same credit language as this bill, but did not pass the Senate Revenue and Taxation Committee.

SB 229 (McPherson, 1999/2000), AB 1081 (House, 1997/1998), and SB 1402 (McPherson, 1997/1998) would have allowed a tax credit similar to the one proposed by this bill. SB 229 and AB 1081 failed to pass the first house by January 31 of the second year, while SB 1402 failed passage in Senate Revenue and Taxation Committee.

Agricultural Water Filter Systems and Equipment Deduction

SB 1521 (Monteith, 1999/2000) contained similar deduction language as this bill, but did not pass the Senate Revenue and Taxation Committee.

PROGRAM BACKGROUND

Irrigation System Improvements Credit

A similar tax credit for the purchase and installation of water irrigation systems expired on December 31, 1985. That credit, taken in the year of installation, was equal to the lesser of 10% of the cost or a maximum of $500 and was provided in addition to any other qualified deductions.

OTHER STATES' INFORMATION

Review of Florida, Illinois, Michigan, Texas, and New York laws found no comparable tax credits or deductions. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

Once the implementation concerns are resolved, this bill is not expected to impact the department's costs significantly.

ECONOMIC IMPACT

Tax Revenue Estimate

This bill would result in revenue losses beginning in 2001-02 as follows:

Revenue Impact of SB 435 Taxable Years Beginning After 1/1/2001 Enactment Assumed After June 30, 2001 $ Millions			
	2001-02	2002-03	2003-04
Irrigation System Improvements	-$17	-$25	-$30
Water Filter Systems	-$4	-$4	-$4
Total Revenue Impact	-$21	-$29	-$34

Any changes in employment, personal income, or gross state product that could result from this measure are not considered.

Tax Revenue Discussion

For the Irrigation System Improvement Costs Credit provision**,** the estimate was developed in several steps. Discussions with industry experts indicated that replacing existing systems as well as the incentive effect of this bill would induce about 200,000 acres of irrigated land in California to adopt water-saving systems or equipment. Discussions with industry experts indicated the average cost per acre to install the equipment and improve the irrigation system was calculated at about $525 per acre for 2000. Total qualifying expenditures are projected to be on the order of $100 million for 2001. The applied credit amounts were adjusted to account for the reduction in depreciation that would result from the use of the credits. The portion of credits that could be applied in any given year against available tax liabilities was estimated using tax returns that report farm income. It was assumed that unapplied carryover credits would be exhausted by the fourth year.

For the Agricultural Water Filtering Systems & Equipment Deduction provision of the bill, the estimates are based largely on information through contacts with California experts in water/agriculture industry. This information indicates that there are no complete systems or equipment to purchase to filter or isolate the contaminated water. The way this is usually done is through constructing systems to direct contaminated water to a specific place. One way of doing this, for example, is through building drainage pipes or what is called tiling, putting plastic sheets in the ground to divert the water flow. Then a water pump is used to pump water from this place to evaporation ponds.

A number of factors affect the costs. Soil conditions as well as the type of contaminant are important factors. Discussions with industry experts indicated the average cost per acre was assumed to be $500. In California about 35 to 40% of acreage can benefit from this proposal due to soil conditions. For this analysis it was assumed, to comply with the federal and state laws, about 40% of California irrigated land (9 million acres) have a filtering system already in place. A double-declining depreciation method was used to calculate deductions under current law assuming 18 years of depreciable life for a typical system. As a result, it is assumed that 1/18 of a typical system is to be replaced each year.

ARGUMENTS/POLICY CONCERNS

Irrigation System Improvements Credit

Because this provision requires an adjustment to basis, it would create a state and federal difference, thus increasing the complexity of tax return preparation. However, disallowing the adjustment would mean that the taxpayer would receive a double tax benefit with respect to the same expenses.

The credit recapture provision would create disparate treatment to taxpayers depending upon their status as a landowner or a lessee of farmland, as well as the timing of use of the credit to offset tax liability. For example, this provision would eliminate the credit carryover of an owner/taxpayer who purchases qualified water application equipment and then sells the land on which the qualified water application equipment had been installed. Conversely, it would allow a credit carryover to a taxpayer that leases the same land and terminates the lease after incurring the costs qualifying for this credit, even if the qualified water application equipment were removed from the leased property. Moreover, an owner/taxpayer that is able to fully utilize the credit against its tax liability in the year of installation would suffer no recapture penalty if the property were sold the following year. This is in contrast with an owner/taxpayer that was unable to use the credit prior to a sale.

The credit does not specify a repeal date or any limitation on the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

Water Filter Systems and Equipment Deduction

Current state and federal laws require businesses and individuals to minimize pollution from their businesses and other activities. This provision would allow a deduction for the construction or purchase of systems and equipment used to prevent contaminated agricultural water from entering public waterways. Tax benefits are typically enacted to encourage behavior, not to reward taxpayers who are simply complying with existing statutes and other laws.

Current federal and state laws allow taxpayers to elect to deduct certain expenses normally chargeable to capital account. However, these deductions are subject to specified dollar limits. The deduction that is allowed by this bill is unlimited.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 435
As Introduced February 21, 2001

AMENDMENT 1

On page 2, line 1, strike "There" and insert:

For each taxable year beginning on or after January 1, 2001, there

AMENDMENT 2

On page 4, line 29, strike "There" and insert:

For each taxable year beginning on or after January 1, 2001, there